FOR ARGUMENT

No. 77-648

In the Supreme Court of the United States

OCTOBER TERM, 1978

FEDERAL ENERGY REGULATORY COMMISSION, PETITIONER

v.

PENNZOIL PRODUCING COMPANY, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION

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I.

Before addressing those contentions of the respondents that warrant a brief reply (pages 7-16, *infra*), we wish to advise the Court of a recent legislative development relevant to this case. As noted in our principal brief (p. 17 n. 9), the 95th Congress was considering the Natural Gas Policy Act of 1978 ("NGPA"), H.R. 5289, 95th Cong., 2d Sess. (1978). On September 27, 1978, the bill as reported by the conference committee (see S. Rep. No. 95-1126, 95th Cong., 2d Sess., to accompany H.R. 5289) was approved by the Senate (124 Cong. Rec. S16265 (daily ed.)), and on October 14, 1978, the same bill and the same conference report (as H.R. Rep. No. 95-1752, 95th Cong., 2d Sess.) were approved by the House (124 Cong. Rec. H13427 (daily ed.)). The bill was signed into law by the

President on November 9, 1978; Pub. L. No. 95-621, 92 Stat. 3350.[1]

We shall discuss the new Act as it appears to bear on the issues in this case.

The court of appeals set aside orders of the Commission refusing to authorize two producers, Pennzoil Producing Company and Shell Oil Company, to pass through to their interstate pipeline customer, the United Gas Pipe Line Company—and hence to United's customers—incremental royalty costs to be incurred in a proposed settlement by Shell and Pennzoil of their lessor's claims under "market value" royalty clauses in the producers' leases. The court also set aside the Commission's rejection of an alternative settlement proposal whereby the producers would have abandoned delivering to United, and paid in kind to their lessor instead, the portion of the gas attributable to the royalties claimed by the lessor. The Commission found that the incremental royalty costs proposed in the settlement were based on the unregulated intrastate market price for natural gas, and held that it was not authorized to allow the pass-through of such costs as just and reasonable rates under the Natural Gas Act. The Commission also held that since the supply of gas in the leaseholds had not been depleted, and interstate service would have to continue even if the properties reverted to the lessor, no basis for abandonment under Section 7(b) of the Natural Gas Act had been shown.

A. The first question in this case is whether the Natural Gas Act authorizes the Commission to include in its rates for the interstate sale of natural gas, and thus to pass on to interstate consumers, royalty costs based on the

[1]Copies of the Act and of the Conference Report have recently been lodged with the Clerk of the Court in connection with Nos. 77-1652 and 77-1654.

unregulated price of natural gas in the intrastate market. Under the Natural Gas Policy Act, all wellhead sales of natural gas after December 1, 1978, will be subject to price ceilings specified in the Act. Thus, there will no longer be an unregulated intrastate market. However, there will still be considerable differences between the allowable prices for intrastate sales and for interstate sales of the kind involved here. Moreover, insofar as this case involves sales of gas made by the respondent producers before December 1, 1978, the validity of the Commission's decision will govern the rights and liabilities of the parties with respect to those sales.

The issue presented here remains significant with respect to sales of natural gas made after December 1, 1978. For such sales, Title I of the NGPA establishes a series of specific maximum price levels to be applied to particular categories of gas (Sections 101(b)(4), 102-109). These ceilings encompass sales made in both interstate and intrastate commerce. One of the categories is gas previously dedicated to interstate commerce under the Natural Gas Act (Sections 2(18), 104, 106(a))—such as the gas involved in this case. Under Section 104(b), the ceiling price for this gas will be the higher of (a) the just and reasonable rate established by the Commission as of April 20, 1977, augmented thereafter by a monthly inflation factor, or (b) any just and reasonable rate established by the Commission between April 20, 1977, and November 8, 1978, which is applicable to the particular gas involved. Section 104(b)(2) provides, however, that the Commission by rule or order may prescribe a ceiling price higher than the ceiling which would otherwise be applicable under Section 104(b), if it finds that the higher ceiling would be just and reasonable within the meaning of the Natural Gas Act.[2]

[2]Under Section 601(b) of the NGPA, amounts paid by natural gas companies in purchasing natural gas after December 1, 1978, will be

Section 106(a) prescribes the ceiling price for "interstate rollover contracts" executed after November 8, 1978—that is, contracts replacing earlier contracts for the sale of gas that was dedicated to interstate commerce before enactment of the NGPA (see Sections 2(12), 106(a)). The ceiling prescribed by Section 106(a) is 54 cents per million Btu's, adjusted for inflation, unless the Commission-established rate previously applicable to the expiring contract is higher, in which case the ceiling is the rate applicable to the expiring contract, augmented by a monthly inflation factor. Under Section 106(c), however, the Commission may prescribe a higher ceiling price than otherwise would be applicable under Section 106(a), if it finds that the higher ceiling is just and reasonable within the meaning of the Natural Gas Act.

Thus, under Sections 104 and 106(a) of the NGPA, the rates previously established by the Commission under the just and reasonable standard of the Natural Gas Act continue to affect sales of gas previously dedicated to interstate commerce—such as the gas involved in this case—and the Commission continues to have authority to prescribe a higher ceiling price for such gas under the same standard.

At the time of the administrative hearing, the gas involved in this case was subject to rates established under the FPC's Opinions Nos. 598 (*Southern Louisiana Area Rate*) and 699 (*First National Natural Gas Rate*). The gas covered by the Southern Louisiana rate had a ceiling price of 31.11 cents per Mcf, including all adjustments; the gas covered by the National Rate had a ceiling of 59.88 cents per Mcf, including all adjustments (A. 42, 66-67). These

deemed "just and reasonable" for the purposes of the rate-setting provisions of the Natural Gas Act if they do not exceed the applicable ceiling established by the NGPA. And under Section 601(c), amounts meeting that test may be passed through by natural gas companies to their customers.

amounts, as adjusted by subsequent Commission orders,[3] will constitute the base price to which the monthly inflation factor will be applied under Sections 104 and 106(a) of the NGPA to determine the ceiling price after December 1, 1978, for gas from these leaseholds flowing under existing contracts, and subsequently under any rollover contracts.

The incremental royalty that Pennzoil and Shell seek the Commission's approval to pass through here would, of course, raise their rates (by the amount of the increment) above these applicable ceilings. The question whether the Commission may approve the pass-through of such incremental royalty costs as "just and reasonable" under the standard of the Natural Gas Act—that is, the question presented in this case—thus persists under the new Act, although its practical significance for the future may be decreased as the differential between interstate and intrastate prices is decreased.

Moreover, if the court of appeals is correct in holding that incremental royalty costs based on the previously unregulated market price may constitute just and reasonable prices passed through to pipelines under the Natural Gas Act, then the base price under Sections 104 and 106(a) of the NGPA will be substantially inflated. Thus, with respect to gas dedicated to interstate commerce and hence subject to Sections 104 and 106(a) of NGPA, the question whether incremental royalty costs arising from "market value" leases referring to the unregulated market may be passed through to producers—that is, held "just and reasonable" under the standard of the Natural Gas Act—will remain significant under the new Act.

[3]The gas covered by Opinion No. 598 is now subject to the rates prescribed in Opinion No. 749 (18 C.F.R. 2.56b(a)(1)). The gas covered by Opinion No. 699 is now subject to the rates prescribed in Opinion No. 770 (18 C.F.R. 2.56a(a)(3)).

B. The second question in this case is whether the Commission properly denied a request to permit lessee producers of natural gas to abandon volumes of gas dedicated to interstate service so that those volumes could be paid as royalties in kind to landowner lessors for sale on the intrastate market.

The NGPA expressly codifies the concept established by decisions under the Natural Gas Act that reserves from which gas is sold in interstate commerce for resale are "committed or dedicated" to interstate commerce.[4] Under Sections 2(18) and 601(a) of NGPA, future sales of gas that was so dedicated on November 8, 1978, remain within the Commission's jurisdiction under Section 1(b) of the Natural Gas Act (subject, however, to NGPA's rate ceiling provisions, and with certain categories of gas excepted). Future sales of gas from reserves so dedicated will therefore remain subject to the conditions of certificates previously issued under Section 7(e), and to the requirement that the service of supplying gas from such reserves may not be abandoned without the Commission's approval. These provisions assure that pipelines presently relying on supplies of dedicated gas may continue to do so. Even though, after December 1, 1978, all producer sales of natural gas, whether interstate or intrastate, will be subject to ceiling prices under NGPA (Section 101(b)(4)), there are significant differences between the ceilings for dedicated gas set by Sections 104 and 106(a) and the ceilings for gas that is not dedicated and hence is not subject to the abandonment requirement of the Natural Gas Act.[5] Thus, if the royalty gas claimed

[4]See, *e.g.*, *California v. Southland Royalty Co.*, No. 76-1114 (May 31, 1978); *Sunray Mid-Continent Oil Co. v. FPC*, 364 U.S. 137 (1960).

[5]For example, under Section 104, the maximum unadjusted December 1978 delivery price for dedicated "flowing gas" (*i.e.*, gas produced from a well on which drilling commenced prior to January

by the lessors under the "market value" clauses should have been abandoned to them prior to NGPA, as respondents contend, there may be substantial price consequences, even if the lessor sells the gas to the same interstate pipeline to which it was delivered under the prior dedication. The abandonment issue therefore remains significant notwithstanding the enactment of the NGPA.

II.

A. Respondents present the decision of the court of appeals as one that would not require the Commission to allow the pass-through of the royalty costs in question, but would only require the Commission to consider whether to do so. As Pennzoil states (Br. at 10 n. 16): "All the decision stands for is the proposition that the Commission has authority to grant relief if a review on the merits demonstrates that such relief would meet the statutory tests." Pennzoil argues that "the Commission has authority to review royalty costs and permit their recovery in rates if found on the merits to be just and reasonable" (*id.* at 13-14), and that "the Commission must at least consider on the merits whether the public interest requires that producers be allowed to recover market value royalty costs * * *" (*id.* at 22-23). See also *id.* at 9 n. 15, 10, 11, 15 n. 20. Pennzoil appears to ask only for "a full inquiry into whether such costs were prudently incurred" (*id.* at 20). Shell presents the case in the same minimal and procedural light:

> In remanding the case to the Commission for rehearing on the merits, the Court of Appeals did not require the Commission to find for the producer. The Commission was merely required to consider the

1973 (43 Fed. Reg. 53270, 53342) is $0.332 per million Btu. 43 Fed. Reg. 53334. In contrast, under Section 109, the maximum unadjusted delivery price for the same month for undedicated natural gas not governed by other provisions (*e.g.*, Sections 102, 103, 108, 109) is $1.630 per million Btu. *Ibid.*

merits of the producers' position, after giving them an opportunity, on a reopened record, to attempt to prove their case.

Shell Br. at 9; see also *Id.* at 12, 15, 19, 31.

But respondents also seek to have it the other way, and in so doing they betray a more accurate recognition of what this case is about. Pennzoil and Shell both take the position that, at least in the case of the rate relief *they* seek on the basis of their proposed state court settlement with their lessor, the Commission would indeed be required to grant the relief. Pennzoil says (Br. at 23): "on that question there can be no dispute," since "[t]he price increase would generate absolutely no profit because it does nothing more than recover increased costs, and no one has claimed the costs to be recovered were other than prudently incurred." And Shell argues (Br. at 20-21) that since the leases were entered into before the Natural Gas Act or before the *Phillips* decision, and since the royalty percentages "conformed with the industry practice in the area at the time, and were necessary in order to purchase the leases"—"[o]n these facts, it is apparent that any holding by the Commission that the royalty provisions of these leases were 'excessive or unreasonable' would be arbitrary and capricious."

These claims by respondents document our contention that the decision of the court of appeals "seems thus to establish a presumption that such relief must be granted unless exceptional circumstances are present" (Commission opening br. at 13; see also *id.* at 22-25).[6] Respondents assert that even though their proposed "market value" royalty increments are based not on a state court judgment or precedent but only on a proposed settlement, the Commission would be required to find them "just and

[6]Compare Pennzoil Br. at 10 n. 16, calling this contention "absurd."

reasonable" and to let them be passed through to pipelines and interstate consumers. Respondents' arguments would apply generally—that is, in the absence of exceptional circumstances—to any royalty costs based on "market value" leases that were held, or that might be held, to refer to the intrastate market. It will typically be the case that such leases were entered into before the Natural Gas Act or before the *Phillips* decision, and that the royalty percentages in the leases conformed with industry practice in the area at the time and hence were necessary in order to purchase the leases.[7] It will always be the case that the requested pass-through relief "would generate absolutely no profit" because it would simply pass through the increased royalty costs.

Given these generic characteristics of claims for "market value" royalties based on the intrastate market, it is illusory to suggest that the decision of the court of appeals would only require the Commission "to hear and review individual requests for rate relief and to determine whether, on the merits, they should be granted" (Pennzoil Br. at 10). Exceptional cases aside, those "individualized" proceedings (*id.* at 17; Shell Br. at 9) would offer nothing individual for the Commission to consider. The facts that are present here—and that respondents contend compel the Commission to grant relief—would be present on a state-wide basis in any state whose courts had held, or might hold, that "market value" royalty clauses refer to the intrastate market. Unless the Commission may exclude such royalty costs from its interstate rates on a

[7]The court of appeals also suggested that these facts would compel the granting of relief: "Determination of the reasonableness of a cost necessarily requires consideration of market price. In all probability, the reasonableness of a great many costs of gas production must be determined by the prevailing market price in an uncontrolled market. The Commission has failed to suggest why royalty costs in an uncontrolled market are any different from any other cost." Pet. App. 7a.

generic basis, on the ground that their inclusion would be improper under the Act,[8] it will be required to include them on a generic basis, and thereby undermine the regulatory scheme. There is no middle ground.

B. The choice made by the Commission was compelled by this Court's decision in *FPC* v. *Texaco, Inc.*, 417 U.S. 380, 394-399 (1974). See our opening brief at 19-21.[9] Respondents contend that the Commission misconstrued that decision (Pennzoil Br. at 15-20; Shell Br. at 13-17). They emphasize particular words from the Court's statements that "the prevailing price in the marketplace cannot be *the final measure* of 'just and reasonable' rates mandated by the Act," that "Congress could not have assumed that 'just and reasonable' rates could *conclusively* be determined by reference to market price," and that "the Commission lacks the authority to place *exclusive* reliance on market prices" (417 U.S. at 397, 399, 400, emphasis added; see Shell Br. at 15). They similarly stress the underlined phrase in the Court's passage:

> This does not mean that the market price of gas would never, in an individual case, coincide with just and reasonable rates or not be a relevant consideration in the setting of area rates, see Permian Basin Area Rate Cases, 390 U.S. at 793-795; *it may certainly be taken into account along with other factors*, Southern Louisiana Area Rate Cases, 428 F. 2d 407, 441 (C.A. 5), cert. denied *sub nom.* Associated Gas Distributors v. Austral Oil Co., 400 U.S. 950 (1970). It does require, however, the conclusion that Congress rejected the identity between the "true" and the "actual" market price.

[8]Pennzoil agrees with us that the decision of the court of appeals precludes the Commission from taking such a position. Pennzoil Br. at 10.

[9]For example, the Court in *Texaco* found unacceptable "the implication * * * that reasonableness would be judged by the standard of the marketplace." *Id.* at 396.

417 U.S. at 399, emphasis added (case name italics omitted); see Shell Br. at 16. Respondents thus contend that royalties based on the price of gas in the unregulated market can be included by the Commission in its determination of reasonable rates—indeed, *must* be included if they were "prudently incurred"[10]—so long as they are not the "exclusive" or "entire" component (Shell Br. at 16-17).

Besides ignoring the thrust of the Court's decision and opinion in *Texaco*, respondents misapprehend the Commission's decision here. Respondents' characterization to the contrary (see Shell Br. at 16-17) notwithstanding, the Commission determined that the incremental royalty embodied in the proposed settlement of the state court suit for royalties based on the unregulated market was indeed based on nothing other than the price in the unregulated market. The Commission found that it was being called on to authorize, as in *Texaco* (see 417 U.S. at 384-385), an automatic "tracking increase" based on the market price for intrastate sales in the same producing area (A. 181-182, 261). Of course, the proposed settlement between Pennzoil, Shell, and their lessor—since it was a settlement—did not pass through the full amount of the "market value" royalties claimed by the lessor. But the Commission found that "the impetus of the settlement is the market value of the royalties and no consideration has been given to regulated rates" (A. 261). Again on rehearing, the Commission found it "plain that the royalty is to be based on 78 cents, which is the settlement's reflection of market prices, that are above the area ceiling

[10]*E.g.*, *Pennzoil* Br. at 20, 23; Shell Br. at 12, 20-21; see pages 7-10, *supra*.

prices" (A. 292). Thus, the Commission's ruling rests on its characterization of the record. The Commission found that it was being asked to approve as "just and reasonable," and to pass through to consumers, incremental royalty costs springing exclusively from the unregulated price for natural gas—the very defect the Court found in the Commission's order in *Texaco* (417 U.S. at 399).[11]

C. Shell contends (Br. at 20-24; A. 285-286) that the Commission's refusal to grant the relief it requested denies it due process and may be confiscatory. Neither Shell nor Pennzoil, however, laid an adequate foundation in the hearing before the administrative law judge for any claim of confiscation. Pennzoil made no showing of either its

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[11]The Commission's finding was not only reasonable but inescapable. Respondents have not suggested any motive for the settlement other than the desire to eliminate the claim being settled. And if it would be improper for the Commission to pass through to consumers the full payment of such claims, settlements must be treated likewise, else the vice is simply discounted. As the Court held in *Texaco*, "the Act makes unlawful all rates which are not just and reasonable, and does not say a little unlawfulness is permitted." 417 U.S. at 399.

Disregarding the impetus for the settlement, Shell and Pennzoil contend that its *computation* was based on factors other than the unregulated market price, including the Commission's ceiling rates (Shell Br. at 10-11; Pennzoil Br. at 6-8). It is hard to see why this would make a difference—suppose the settlement was computed as ten times the regulated rate—but in any event the record does not support the claim. The record shows only the settlement formula, under which the royalty was to be based on the higher of 78 cents per Mcf (with adjustments) or 150% of the highest Commission-set area or national rate (A. 17-18). The record provides no support for Pennzoil's claim (Br. at 7) that the 78-cent figure was calculated as 150% of the Commission's then-existing national rate, so that in either form "the incremental royalty is tied directly to Commission set rates and not at all to intrastate rates" (*ibid.*; footnote omitted). If this were true, it would be at odds with the settlement's alternative provision for abandonment of the "royalty gas" (A. 20-21), which is plainly designed to allow sale of that gas in the intrastate market.

overall or its out-of-pocket costs for operating the properties involved (A. 175-176). Shell offered some evidence concerning its costs and revenues, but none concerning its capital costs, and none with respect to revenues from condensates produced from the wells involved (A. 175-180). Moreover, Shell's claims of operation at a loss were computed on the basis of the unadjudicated $1.40 per Mcf "market value" figure claimed by the lessor, not the 78 cents per Mcf figure agreed to by the lessor in the proposed settlement that was before the Commission (A. 180). The administrative law judge found that on the basis of that settlement, without reference to capital costs or condensate revenues, Shell would earn a profit from gas operations under the 1934 and 1952 leases of $178,951 in 1975 (A. 178-179).[12]

Because Shell and Pennzoil failed to make a case for confiscation, there is no occasion on this record to determine whether the Commission's adherence to this Court's holding in *Texaco* would ever present a confiscation issue. The Commission's decision here does not preclude—under the Constitution and the Act it could not preclude—consideration of the issue if it should be adequately presented. See *California* v. *Southland Roy-*

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[12]Shell says (Br. at 21-22) it was improper for the administrative law judge to use the 78 cent settlement figure instead of the $1.40 figure claimed in the litigation,because "[i]f the Commission denies the relief requested, there is no settlement * * *" (*id.* at 21). Thus, having presented the settlement to the Commission for a ruling, Shell complains that the Commission ruled on it. As the administrative law judge pointed out (A. 180), if the settlement is terminated because of the Commission's refusal to grant the relief sought, that will be the choice of Shell or Pennzoil, not of the lessor (and not of the Commission).

alty Co., No. 76-1114 (May 31, 1978), op. slip. 8; *Mobil Oil Corp.* v. *FPC*, 417 U.S. 283, 328 (1974).[13] It was not adequately presented here.[14]

D. Respondents concede that this Court's decision in *California* v. *Southland Royalty Co.*, No. 76-1114 (May 13, 1978), wipes out the court of appeals' ground for setting aside the Commission's refusal to permit them to abandon delivery of the royalty portion of the gas and pay it in kind to the lessor. They contend, however, that the public convenience and necessity required abandonment, even though the gas supply was not depleted, because if the lessor prevails in state court, respondents might lose the leases or be required to cease drilling additional wells. Shell Br. at 26-31; Pennzoil Br. at 25-28. In addition, they contend that if the property reverts to the lessor, the lessor might qualify as a small producer entitled to charge higher rates than those presently applicable. See 18 C.F.R. 157.40; Shell Br. at 30; Pennzoil Br. at 27. Respondents contend that the Commission did not deal explicitly with these arguments and that the case should now be remanded for it to do so (Shell Br. at 27, 31; Pennzoil Br. at 27-28).

The Commission's rejection of the abandonment proposal was, however, inclusive. It found "no reason to grant abandonment on the basis of this record," and further that "the public convenience and necessity, present or future, is not served by granting an abandonment authorization that would likely result in the subject gas being diverted from the interstate market to the intrastate market" (Pet. App. 24a). In any event, respondents did not raise on rehearing the arguments they now say the Commission should consider. Pennzoil contended only that the substitution of the lessor for itself and Shell would substitute an inexperienced royalty owner for experienced producers (A. 280). Shell argued only that the Commission should have permitted one of the alternatives provided in the proposed settlement, and that it erred in failing to consider that rejection of both might result in victory for the lessor in the lawsuit and hence in loss of the gas supply to the pipeline (A. 283-284). Thus, the arguments now put forward were not preserved on rehearing as required by Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

United Gas Pipe Line Company did argue on rehearing that even if the gas remained in interstate commerce, the lessor might qualify for the small producer rates, thus increasing the price for the gas (A. 287-288). United, however, does not make this argument in its brief in this

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[13]The Commission noted the speculative and premature nature of the "bind" in which Shell and Pennzoil claimed to find themselves:

> The real issue in this proceeding is whether the * * * Commission can legally grant any form of rate relief above either an area or nationwide just and reasonable rate solely because the producer selling the gas in interstate commerce *may* be obligated to make a royalty payment based not upon the regulated price the producer receives for the gas, but rather on the "market value" of the gas. Moreover, as in this proceeding, the question becomes somewhat speculative because of litigation between producer lessees and lessors over the extent of such royalty obligations. [Pet. App. 21a; emphasis in original.]

[14]Pennzoil cites (Br. at 20-25) two Commission decisions as supporting the pass-through of royalty costs based on the unregulated market. Those decisions are inapplicable here. In *El Paso Natural Gas Co.*, Docket No. RP72-150 (Feb. 16, 1977), the Commission noted that "unlike in *Pennzoil*, this case does not involve a request for special relief above applicable Commission determined and Court approved just and reasonable ceiling rates" (slip op. 15). The case involved special circumstances concerning a pipeline; the Commission's rate-setting scheme for pipeline-owned production allows an individual cost-of-service approach in special circumstances. See 18 C.F.R. 2.66. In *Columbia Gas Transmission Corp.*, Docket No. RP73-65 (Aug. 1, 1977), the Commission held that a pipeline's purchased gas costs for non-jurisdictional gas should not be excluded from its base so long as they were reasonable and prudent. The present case involves jurisdictional gas.

Court (see United Br. at 20-23).[15] In any event, none of the parties before the Commission presented any evidence in this record indicating that the possibility of an increase in rates from national to small producer levels warranted abandonment of service under the existing contracts.

CONCLUSION

For the reasons stated in the Commission's principal brief and in this reply brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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[15]The contention is unsupported in any event. The administrative law judge found that the lessor, Williams, could not qualify for the small producer rate, since sales from these leases exceed 10 million Mcf a year (A. 184; see 18 C.F.R. 157.40(b)).